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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of
1993 Annual Access
Tariff Filings

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) CC Docket No. 93-193
)

DIRECT CASE OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company
and
New England Telephone and
Telegraph Company

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Dated: July 27, 1993

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DIRECT CASE OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company ("NYT") and New England Telephone and Telegraph Company ("NET"), collectively the "NYNEX Telephone Companies" or "NTCs", hereby file their Direct Case in the above-referenced proceeding. In this filing, the NTCs respond to issues 1, 2, 6 and 7 of the Common Carrier Bureau's June 23, 1993 Designation Order.¹

SUMMARY OF DIRECT CASE

The attached exhibits provide the response of the NYNEX Telephone Companies to the relevant issues under investigation. The following is a summary of the position of the NTCs on each issue:

¹ In the Matter of 1993 Annual Access Tariff Filings, CC Docket No. 93-193, Memorandum Order and Order Suspending Rates and Designating Issues For Investigation, DA 93-762, released June 23, 1993.

1. Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the TBO amounts under the Commission's price cap rules?

ANSWER: Yes. The NTCs have demonstrated that the proposed \$12 million exogenous adjustment to recover a very modest portion of the incremental impact of SFAS-106 on OPEB costs complies fully with the Commission's price cap rules.² First, the costs at issue will be incurred as a result of an FCC-mandated accounting change which the NTCs are powerless to control. The price cap rules do not require, as some parties have suggested, that the NTCs also demonstrate that they had no control over the level of OPEB costs. Second, the TBO costs at issue are not included in the GNP-PI; and there is no double-count arising from intertemporal adjustments, rate of return or productivity factor.

2. How should price cap LECs reflect amounts from prior year sharing or low-end adjustments in computing their rates of return for the current year's sharing and low-end adjustments to price cap indices?

ANSWER: The LECs should normalize their rates of return for purposes of computing their current year sharing or lower formula adjustments ("LFAs") by "adding-back" prior year sharing amounts and by removing revenues associated with prior year LFAs. If a LEC did not normalize its earnings by removing the effect of an LFA, its earnings could be driven below the level that the Commission has defined as confiscatory. In the Designation Order, the Commission noted that it was issuing a

² Abbreviations used herein are referenced in the text.

notice of proposed rulemaking that would require the LECs to add-back sharing and remove LFA revenues from their rate of return reports. In the NTCs' view, the NPRM simply clarifies a requirement that is implicit in the Commission's Price Cap rules. Add-back is necessary to enforce the upper and lower earnings limitations that are an essential aspect of the Price Cap system. While the LEC Price Cap Order did not discuss normalization, it also did not eliminate the continuing requirement that the LECs report earned revenues in their Form 492 rate of return reports. It also did not alter the rule that the LECs are responsible for demonstrating the reasonableness of their tariff filings and for submitting sufficient information to support their tariffs. The NTCs demonstrated in their 1993 Annual Access Tariff Filing that they properly normalized their 1992 rate of return by removing the effect of the 1992 LFA in computing their sharing obligation for the 1993-94 tariff period.

6. Have the LECs properly reallocated GSF costs in accordance with the GSF Order?

ANSWER: In Attachment A to Exhibit 3 of this filing, the NTCs have attached the relevant portions of their June 17, 1993 GSF compliance tariff filing. These materials include Workpaper Delta Y, which was inadvertently omitted from the June 17 filing and which the NTCs submitted in an amended filing on June 23, 1993. Attachment A explains the methodology that the NTCs used to reallocate GSF costs and it provides the data and workpapers underlying the exogenous adjustments for GSF cost shifts. These data show that the NTCs reallocated GSF


costs among the price cap baskets in accordance with the Commission's rules.

7. To what category or categories should the LIDB per query charges be assigned?

ANSWER: In the 1993 Annual Access Tariff Filings, all LECs, except United, placed Line Information Database ("LIDB") rates in the Local Transport service category. LIDB charges should remain in the Local Transport category because they are associated with rates for common channel signaling access ("CCSA"), which are also in the Local Transport category. Because LIDB customers use the CCSA Link charges for access to the LIDB database, it is reasonable to include the LIDB

transport and query charges in the Local Transport category. This is consistent with the Commission's finding in the LEC Price Cap Order that services with similar customer bases, demand characteristics, and technology should be in the same category.

Respectfully submitted,
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New England Telephone and
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Dated: July 27, 1993

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ISSUE NO. 1: Have the LECs borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the TBO amounts under the Commission's price cap rules?

ANSWER: Implementing SFAS-106 results in an exogenous cost change for the TBO amounts under the FCC's price cap rules

I. INTRODUCTION AND COMPANY POSITION

In its Order released June 23, 1993 (Designation Order), the Bureau granted, subject to investigation and accounting order, the NTCs' proposed \$12 million exogenous adjustment to recover a very modest portion of the incremental impact of SFAS-106 on OPEB costs.¹ The NTCs' request was limited to the TBO for current retirees. The Bureau designated for investigation (para. 105) the issue of whether implementing SFAS 106 results in an exogenous cost charge for the TBO.

have no control over the accounting treatment mandated by the Commission. Compliance with the Commission's rules requires the NTCs to reflect on their regulated books of account higher costs than previously were required under the "pay-as-you-go" rule. Having mandated such a change, it would be patently unfair for the Commission to deny the NTCs recovery of costs that they will prudently incur.

Even if our opponents' interpretation of the legal standard were correct, which it is not, the NTCs do not have "control" of TBO costs. Unlike decisions affecting capital expenditures -- viewed by the Commission as entailing significant BOC control -- benefit costs are, in large measure, the result of bilateral collective bargaining discussions between the ~~companies~~ and unions representing craft. It is

II. BACKGROUND AND ORGANIZATION OF FILING

A. Background On SFAS-106

In December 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 106 (SFAS-106), Employers' Accounting for Postretirement Benefits Other Than Pensions (OPEBs). SFAS-106 changed the way companies subject to Generally Accepted Accounting Principles (GAAP) must account for OPEBs.² OPEBs are those benefits, outside of the pension plan, provided by employers to retirees, their beneficiaries and covered dependents. The NYNEX Corporation maintains OPEB plans for management and non-management employees which encompass medical and dental retiree health plans and retiree life insurance plans. SFAS-106 accounting was required for fiscal years beginning after December 15, 1992, with earlier implementation encouraged.

Prior to January 1, 1993, the NTCs accounted for OPEBs on a "pay-as-you-go" (cash) basis, which reflected amounts actually paid for retirees each year for OPEBs. SFAS-106 changed this accounting by requiring that OPEBs be accounted for on an accrual basis which recognizes OPEBs as a form of deferred compensation earned by employees as they

² See Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions", Order of Investigation and Suspension, DA 92-540, CC Docket No. 92-101, released April 30, 1992, ("OIS"), para. 2.

provide service to the employer.³ Companies also have to reflect the amount of their unrecognized net OPEB obligation for these benefits to retirees, and the earned portion relating to active employees existing as of the date of adoption of SFAS-106. This unrecognized net OPEB obligation is referred to as the Transition Benefit Obligation (TBO).

Under SFAS-106, the amount accrued as the cost of OPEBs for a period is the "Net Periodic Postretirement Benefit Cost" and the components are defined as follows:

(1) Service Cost: This component represents the portion of the Expected Postretirement Benefit Obligation ("EPBO") earned by employees during the current accounting period. The EPBO is the actuarial present value as of a particular date of the benefits expected to be paid to or for an employee, the employee's beneficiaries, and any covered dependents pursuant to the terms of the postretirement benefit plan.

(2) Interest Cost: This component is the product of the assumed discount rate times the beginning of the year accumulated postretirement benefit obligation ("APBO"). The APBO represents the portion of the EPBO earned to date as a result of past employee service. Interest cost represents the increase in discounted plan liabilities that occur as a result of the passage of time.

(3) Actual Return on Plan Assets: This component represents the return on plan assets permanently set aside to satisfy future plan obligations and is a reduction to the net periodic postretirement benefit cost.

(4) Amortization of Unrecognized Prior Service Costs: This component represents the ratable recognition of the cost of plan amendments that increase or decrease benefits attributable to prior periods.

(5) Amortization of Unrecognized Gains and Losses Deferred: This component represents the ratable

³ SFAS-106 Summary, p. 1 (December 1990).

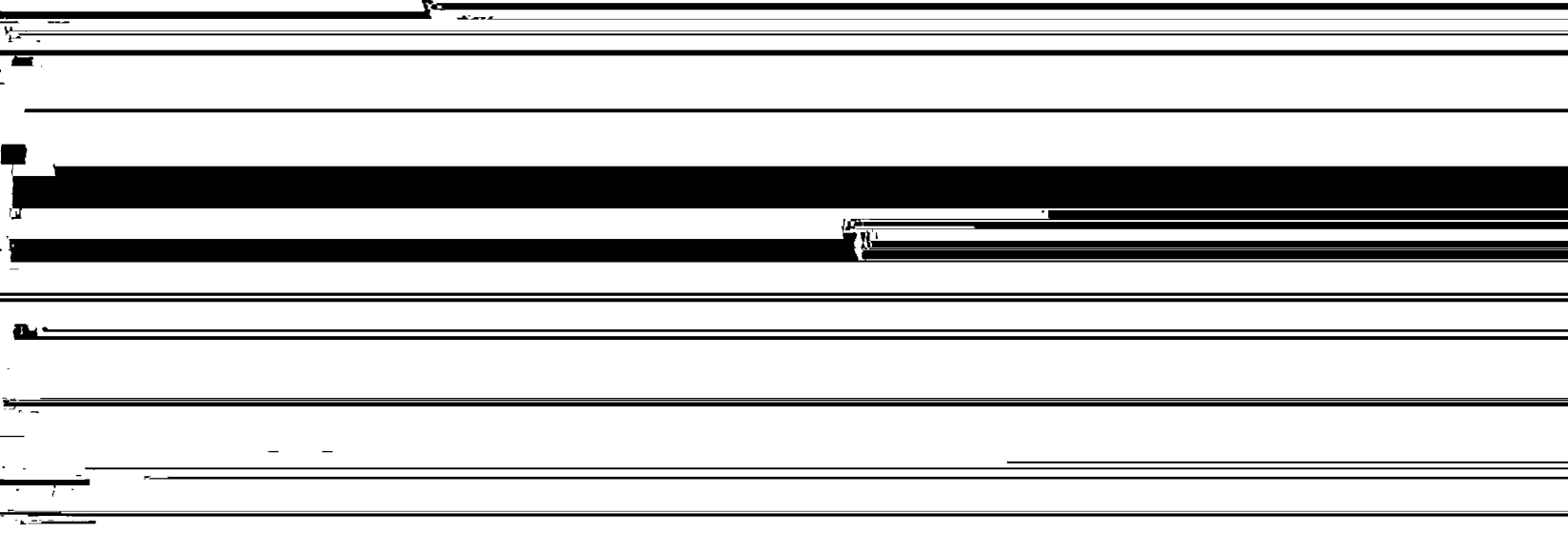
recognition of the net effects of prior years' unrecognized gains and losses. Gains and losses may be either changes in the amounts of the APBO or the plan assets that have resulted from experience different from that assumed or from changes in assumptions.

(6) Amortization of the Transition Obligation: This component represents the ratable amortization of the unrecognized net OPEB obligation or asset existing at the initial application date of the final standard.⁴ This is the difference between the APBO and the fair value of plan assets (adjusted for any related amounts on the employer's balance sheet) as of the date of adoption. This amount is amortized using straight line amortization over the greater of the average remaining service period of active employees or twenty years.

On December 26, 1991, the Commission issued an Order requiring all carriers to adopt SFAS-106 on or before January 1, 1993, using the amortization method of recognizing the TBO.⁵

Section 32.16 of the FCC's Rules⁶ provides in relevant part:

The company's records and accounts shall be adjusted to apply new accounting standards prescribed by the Financial Accounting Standards Board or successor authoritative accounting standard-setting groups, in a manner consistent with generally accepted accounting principles. Commission approval of a change in accounting standard will automatically make effect 90 days after the announcement of the change.



This rule effectuates the Commission's prior determination that GAAP changes shall be incorporated into the Uniform System of Accounts (USOA) for accounting purposes to the extent regulatory considerations permit.⁷ As the OIS described: "Pursuant to Section 32.16, the Bureau issued an Order authorizing all subject carriers to adopt SFAS-106, on or before January 1, 1993, as a mandatory practice for purposes of the USOA."⁸ That Order by the Common Carrier Bureau provided that (para. 3): "after reviewing SFAS-106, we have concluded that its adoption for accounting purposes will not conflict with the Commission's regulatory objectives." Regarding the TBO, the Bureau stated that "carriers should use the period(s) set forth in paragraphs 112 and 113 of SFAS-106 for amortizing the transition obligation for regulatory purposes."⁹

Pursuant to the above Commission requirement, the NTCs adopted SFAS-106 effective January 1, 1993.

B. The Commission's Docket 92-101 Proceeding

In response to several price cap LECs' tariff filings, the FCC established CC Docket No. 92-101 to address the issue of exogenous treatment of the costs associated with

⁷ Revision of USOA For Telephone Companies To Accommodate GAAP, CC Docket No. 84-469, Report and Order released November 14, 1985, 102 FCC2d 964 (GAAP Order).

⁸ OIS para. 3, citing Southwestern Bell and GTE Service Corp.-- Notification of Intent to Adopt SFAS-106, Order released December 26, 1991, supra.

⁹ See RAO Letter 20 released April 24, 1992, p. 2.

implementing SFAS-106. The OIS made all price cap LECs, including the NTCs, parties to the proceeding.¹⁰ Following the receipt of price cap LEC direct cases, oppositions and replies, the Commission released an Order on January 22, 1993 (OPEB Order). The Commission denied exogenous treatment based on the record before it (para. 1), but indicated price cap LECs could pursue this issue in, e.g., their annual access tariff filings:

We do not foreclose these carriers or others from making a more persuasive showing in the context of the 1993 annual access filings.... Our decision in this case is not intended to foreclose further consideration of exogenous treatment of TBO amounts, based on a better and more complete record, for example, in the annual 1993 access tariff filings.¹¹

C. The NTCs' Annual Filing

Pursuant to the OPEB Order, the NTCs' April 2, 1993 Annual Tariff filing included the TBO portion of OPEB

reflects, among other things, aggressive caps on these benefit costs.

More specifically, as a result of adoption of SFAS-106, the incremental cost for the NTCs is \$178 million for calendar year 1993. The interstate exogenous adjustment proposed by the NTCs was \$8,065,704 for calendar year 1993 and was based on exogenous treatment for the interstate portion of the TBO for current retirees. The exogenous adjustment was based on the NTCs' adoption of SFAS-106 on January 1, 1993. The effective date of rate revisions for the annual filing was July 1, 1993. Therefore, the OPEB exogenous adjustment for purposes of the 1993 Annual Price Cap Filing was \$12,098,556 to account for the full eighteen month effect. The NTCs will make an adjustment in the 1994 Annual Access Filing to remove the effect of the exogenous adjustment for the first half of 1993.

D. The Designation Order

In provisionally granting LECs' exogenous adjustments for TBO amounts, the Bureau stated that the LECs' submissions included

complex analysis and reasoning that demand equally complex review.... The record associated with the 1993 annual price cap filings is inconclusive concerning the control issue.... The record concerning double counting in the GNP-PI has been enhanced by a second Godwins study. However, other potential areas of double counting discussed in the OPEB Order have not been sufficiently addressed. These include: the intertemporal double counting issue; double counting related to the inclusion of costs in the prescription of the rate of return which determined the initial price cap rates; and

the anticipation of SFAS-106 costs in the studies underlying the productivity factors.¹³

In the next section of this Direct Case, we address these control and potential double count issues as referenced in the Designation Order.

Furthermore, in designating OPEB issues, the Bureau made the following information requests (para. 105.1):

We direct the LECs to provide evidence of and describe the ranges of data on the age of the workforce, the ages at which employees will retire, and the length of service of retirees, presented by their actuaries and used by the companies to compute OPEB amounts claimed in the annual access transmittals.

We direct the LECs to provide pertinent sections of their employee handbooks, contracts with unions, and other items that include statements to the employees concerning the company's ability to modify its post-employment benefits package.

The NTCs respond to the first paragraph above (on actuarial data) in Appendix A hereto, and we respond to the second paragraph (on statements to employees) in Appendix B.

E. Exogenous Cost Justification

Under FCC price cap regulation, costs are eligible for exogenous treatment if they are triggered by administrative, legislative or judicial action beyond the control of carriers.¹⁴ FCC Rule 61.45(d) specifies

¹³ Designation Order para. 29.

¹⁴ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, released October 4, 1990, 5 FCC Rcd 7664, para. 166 ("LEC Price Cap Order").

exogenous treatment for LEC cost changes as permitted or required by the Commission. Cost changes arising from GAAP changes are eligible for exogenous treatment pursuant to Commission approval.¹⁵ Under FCC Price Cap rules, if a GAAP change has been ordered by the FCC to be reflected in regulatory accounting, exogenous treatment should be granted to the extent there would be no double counting of costs in, e.g., the GNP-PI.

With respect to GAAP changes, the Commission has stated that carriers must notify the FCC of their intent to adopt such changes:

carriers are not authorized to adjust their price caps automatically to reflect changes in generally accepted accounting principles (GAAP).... Carriers must notify us of their intention to apply a change in GAAP and we will allow such change if we find it to be compatible with our regulatory needs. No carrier may adjust its price caps to reflect a change in GAAP until we have approved the carrier's proposed change.¹⁶

Furthermore, in the LEC Price Cap Reconsideration Order, the Commission declared with respect to OPEBs and SFAS-106:

no carrier could treat GAAP changes as exogenous until we approved the change, and ... exogenous treatment would not be granted until FASB had

¹⁵ LEC Price Cap Order para. 168.

¹⁶ LEC Price Cap Order para. 168. See also: FCC Rule 61.45(d); AT&T, Transmittal No. 2304, Order released June 27, 1990 (DA 90-878), para. 4 ("the accounting change AT&T seeks to claim as exogenous [SFAS-106] will probably be mandated by FASB in 1992, and at that time qualify for exogenous treatment.... [E]xogenous costs [associated with USOA changes] can be either cost changes resulting from a change in [FCC] accounting rules or in any Commission-approved change in GAAP.")

actually approved a change in GAAP, and the change became effective.... Further, the test of whether to grant exogenous treatment of GAAP changes is not restricted to whether the change is outside the control of the carrier.... [T]he determination of whether a particular GAAP change is exogenous includes an analysis of whether the cost change will be reflected in the inflation variable of the PCI. If a GAAP change is universal enough to be reflected in the inflation measure, exogenous cost treatment would result in double counting within the context of the PCI.¹⁷

Finally, the Commission has emphasized that:

GAAP changes should be eligible for exogenous treatment after a case-by-case review indicates that the change will not be adequately reflected in the GNP-PI.¹⁸

As noted, under the OPEB Order, the test for whether GAAP changes should be treated as exogenous has two prongs. First, is the imposition of the costs not within the control of the price cap carrier? Second, are the costs not reflected in the price cap formula, e.g. the GNP-PI? If the answer is yes to both questions, then the GAAP change should be treated as exogenous.

III. THE FCC'S TWO-PRONG TEST FOR EXOGENOUS TREATMENT

A. The NTCs Have No Control Over The TBO Costs At Issue

First, all parties have conceded that the SFAS-106 accounting change was mandated by the FASB and FCC,

¹⁷ LEC Price Cap Reconsideration Order, released April 17, 1991, 6 FCC Rcd 2637, paras. 59, 63; OIS para. 6.

¹⁸ CC Docket No. 87-313, AT&T Price Cap Reconsideration Order, released February 8, 1991, 6 FCC Rcd 665, para. 75, cited in LEC Price Cap Reconsideration Order para. 63 and n. 68.

and was beyond the NTCs' control. The NTCs were ordered by the Commission to implement SFAS-106 accounting for regulatory purposes by January 1, 1993. When issuing SFAS-106, the FASB also required adoption by January 1, 1993 for financial accounting purposes.

Second, having carried out the requirement to implement SFAS-106 accounting, the NTCs are significantly constrained by the FASB standard itself. Under that standard, we must accrue some TBO costs that represent, under all the circumstances, a "promise" or "obligation" in "exchange" for retirees' past service.¹⁹ That past service obviously has been completed, and is also beyond our control at this point.

It bears emphasis that throughout this proceeding, the NTCs' request for exogenous treatment has been limited to the incremental effect of this compulsory accounting change. That is, we have sought rate recognition only for the TBO minus the pay-as-you-go OPEB costs. This increment was necessarily positive, since it represents our "promise" to pay OPEBs to current retirees in respect of their past services which have benefited ratepayers. In a sense, the TBO is a "true-up" to pay-as-you-go amounts to bring the NTCs into full compliance with SFAS-106.

Importantly, SFAS-106 does not prescribe a strict legalistic standard of control in order to accrue a

¹⁹ SFAS-106 Summary, p. 1. As also stated therein: "The Board [FASB] believes that measurement of the obligation and the accrual of the cost based on best estimates are superior to implying, by a failure to accrue, that no obligation exists prior to the payment of benefits."

liability. Thus, for example, to accrue some liability, there need not be a legally indisputable inability to modify postretirement benefits, nor an explicitly clear ERISA²⁰ right of retirees to OPEBs. As the FASB Standard concluded:

the Board has looked beyond the legal status of the promise to consider whether the liability is effectively binding on the employer because of past practices, social or moral sanctions, or customs.²¹

Under SFAS-106, a company must accrue the OPEB obligation unless it has discretion to avoid paying these benefits without significant penalty:

It could refuse to pay only by risking substantial employee-relations problems. As a practical matter, it is unlikely that an employer could terminate its existing obligations under a postretirement benefit plan without incurring some costs.²²

Accordingly, it would be unfair and inappropriate for the Commission to require us to book TBO costs under one standard (SFAS-106) as above, and then apply a different, legalistic standard to disregard those costs in rates.

Some of our opponents have previously asserted that since we have some control over paying OPEBS, these costs are totally ineligible for exogenous treatment. This argument is without merit. It confuses the amount of OPEB costs that

²⁰ Employee Retirement Income Security Act.

²¹ SFAS-106 para. 156.

²² Id. para. 157.

should be recovered with the issue of whether exogenous treatment should be granted at all. Moreover, if our opponents' view were to be accepted, then virtually all types of costs would be ineligible for exogenous treatment. Section 61.45(d) of the Commission's rules provides a nonexclusive list of cost changes eligible for exogenous treatment: completion of amortization of depreciation reserve deficiencies; changes in Uniform System of Accounts²³; changes in the Separations Manual; changes to the level of obligation associated with the Long Term Support Fund and the Transitional Support Fund; reallocation of investment from regulated to nonregulated; tax law changes and other extraordinary exogenous cost changes; retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark; and inside wire amortizations. If one were to scrutinize any of these eligible exogenous cost items, it is clear that the company has some decision-making power that impacts the quantification of the costs. For example, even a tax rate change mandated by the government is applied to items (such as revenues) over which the company has some control. The FCC could not have intended that having some control over the level of underlying costs will render a cost item

²³ As noted, Commission Orders indicate this also includes required GAAP changes.

ineligible for exogenous treatment.²⁴ Such an approach
would essentially negate all items eligible for exogenous
treatment making Section 61.45(d) a nullity.

must meet the standards for approval established by our enrolled actuary and those set by our external auditors. Within these constraints, our assumptions and parameters are very aggressive in the direction of keeping down OPEB accruals.

Third, on a practical level, we have no ability to further curtail these TBO costs. It would be impossible in the real world to exercise the type of draconian control over these benefits that some parties have previously posited in using a legalistic notion of the control test for exogenous treatment. In short, if the NTCs tried to further cut or eliminate these benefit costs, they would face potentially dire consequences, including work stoppages, lawsuits, retirees not able to meet health care costs, adverse publicity, etc.

OPEB benefits are part of a total compensation package that generally is determined through the supply/demand process in labor markets. Specifically, the NTCs and other price cap LECs have a significant portion of the total compensation costs determined through the collective bargaining process with union-represented employees. This process, in turn, is affected by total compensation packages for employees of comparable skills in the general economy. We could not make significant alterations to our benefit package without consideration of 1) the collective bargaining process -- indeed, in 1989 the NTCs experienced a bitter and costly work stoppage over the central and highly emotional issue of a proposed reduction of medical benefits; 2) the promise made to retirees; and 3) impact on our ability to attract and retain employees. As stated in the literature:

Legal and practical considerations may make the benefits [OPEBs] a fairly fixed obligation. As a legal matter, the ability of employers to cancel or amend benefits is highly uncertain, owing to different precedents established in various circuits of the federal courts in interpreting the language of contracts and the intentions of relevant parties. More importantly, as a practical matter, concerns about ethics, labor relations (particularly in a unionized environment), and public relations impose constraints on the ability of employers to act unilaterally on this issue.²⁶

Were the NTCs to curtail these benefits, lawsuits could be brought against us based upon a variety of legal theories, including implied contract and promissory estoppel. Any litigation will be fraught with significant risk and expense.

In addition, we face real constraints in cutting OPEBs in view of the sustained increases in medical benefits, and the political climate to protect retirees and workers.

Our opponents have argued, erroneously, that the LECs have the same ability to control TBO costs as they do depreciation rates. In denying exogenous treatment for depreciation rates, the Commission indicated that although those rates are prescribed by federal and state regulatory agencies, LECs could exercise significant control over future decisions on the amounts and timing of plant investment and retirements.²⁷ There is little similarity in the control of

²⁶ H. Fred Mittelstaedt and Mark Warshawsky, The Impact of Liabilities for Retiree Health Benefits on Share Prices, Federal Reserve Board Paper # 156, April 1991, p. 3.

²⁷ See LEC Price Cap Order para. 182; LEC Price Cap Reconsideration Order para. 74.